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# Summary of recommendations for revision of the revenue laws; Proposed changes in the federal revenue law

American Institute of Accountants. Committee on Federal Taxation

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Summary of recommendations for revision  
of the revenue law  
American Institute of Accountants

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135 CEDAR STREET, NEW YORK

July 26, 1938

IMPORTANT

To the Presidents of State Societies  
and other Interested Parties:

On June 28, we wrote to all of the state societies of certified public accountants and certain other individuals requesting recommendations for the revision of the Federal Revenue Act. To those who have responded, we extend our sincere thanks.

The Institute's committee on Federal taxation has assembled all of its recommendations, augmented by suggestions which have come from others. We now enclose, in duplicate, a summary of these proposals, and earnestly solicit your prompt consideration of this material.

In several cases, there have been included proposals which the committee does not approve, but which have been submitted by those whose opinions have been sought. For example, alternatives are offered relative to the retention of the undistributed-profits tax, although the committee is unalterably opposed to the principle of this tax. Similarly, someone wants to revoke the option of husband and wife to be taxed separately or jointly.

Will you sign, and return to us, one copy of the enclosed document, indicating clearly your approval or disapproval of each item? If you have qualifications or other suggestions, please submit them in a separate letter for further consideration. We call your attention particularly to the items marked with asterisks, in respect of which we should like to have additional supporting data or suggested language.

The committee wants to prepare a tabulation of the replies which will express a nationwide cross-section of the opinions held by accountants, and to use such support in advocating revisions in the conferences which are scheduled in the Treasury Department during August.

Again, many thanks for your cooperation. We shall appreciate a prompt reply.

John L. Carey  
Secretary

AMERICAN INSTITUTE OF ACCOUNTANTS  
Committee on Federal Taxation

Summary of Recommendations for Revision of the Revenue Law

General Considerations

	<u>Approval</u>	<u>Disapproval</u>
1. Taxation should be based upon fixed principles having a closer relation to sound accounting procedure and conservative business practice.		
2. The tax burden should be equalized and the federal revenue stabilized by the adoption of moderate rates of taxation which encourage enterprise, and thereby increase employment.		
3. Congress should create a qualified, non-partisan commission - selected from the legal, accounting, economic, political and commercial fields - to establish fixed principles of income taxation and related administrative procedure.		
4. The Government should adopt a sensible income tax program with a base <u>broad</u> enough to supply all the revenue needed and a foundation firm enough to provide a steady dependable source of revenue.		
5. Personal exemptions for single persons should be reduced to \$800. from \$1,000., and for married persons and heads of families from \$2,500. to \$2,000.		
6. Broadening of the base by means of reduced exemptions and a graduated normal tax, should be coupled with effective withholding at the source.		
7. Repeal the inelastic "nuisance" taxes which work such a hardship on the low income class of our population, as such taxes are not in accord with the principle of taxation upon the basis of the taxpayer's ability to pay.		

	<u>Approval</u>	<u>Disapproval</u>
8. Taxation legislation should be enacted with a view only to the raising of revenue and not for social, punitive or regulatory purposes.	_____	_____
9. For Federal income tax purposes, husbands and wives in the eight Community Property Law states should be taxed the same as in other states.	_____	_____
10. Section 803 requiring the filing of returns as to formation, etc., of foreign corporations should be repealed. It imposes unnecessary burdens on accountants inasmuch as such information can best be obtained from officers, directors, stockholders and attorneys directly concerned.	_____	_____
11. A careful reading of Section 820 indicates that it is less comprehensive than originally intended. It fails to cover adjustments in the case of disallowed deductions, except under certain exceptional circumstances, and it contains no provision for consistent and equitable treatment of items that may be involved in the determination of both estate tax and income tax. Moreover, the section is exceedingly involved and complicated and should be stricken from the law until it can be redrafted on the basis of conferences between Congressional and Treasury experts and members of the legal and accounting professions as to methods of avoiding double deductions and double taxation and at the same time preserving fairness and administrative feasibility.	_____	_____
12. Congress should consider the elimination of the reciprocal exemptions accorded by the State and Federal Governments to the interest on Federal, State and municipal securities and to the salaries of Federal, State and municipal officers and employees.	_____	_____

	<u>Approval</u>	<u>Disapproval</u>
13. The time for filing Federal income tax returns should be extended to the 15th day of the fourth month following the close of the taxable year. In respect of instalment payments, the law could be amended to provide for the payment of one-quarter of the total tax on or before the 15th day of the fourth month following the close of the taxable year and one-fourth on the 15th day of the sixth, ninth and twelfth months. This would not lessen the Government's revenue in any fiscal year and at the same time it would not be inequitable to taxpayers.	_____	_____
14. The law should set forth a satisfactory definition of "earnings or profits", in order that individuals may be better able to ascertain whether the dividends they receive are taxable and in order that corporations may be enabled to know in advance whether the dividends they distribute will be taxable in the hands of their shareholders.	_____	_____
<u>Corporate income taxes</u>		
15. The present maze of taxes on corporations should be replaced by one tax, however stiff may be the resulting rates.*	_____	_____
16. The tax burden needs to be equalized as between corporations with normally steady incomes and corporations with violently fluctuating earnings.*	_____	_____
17. Corporate income should be taxed on the basis of average earnings for 5 years, since it is inequitable to exact heavy taxes upon the full profits of successful years without relief in respect of unprofitable years which inevitably follow.	_____	_____
18. If the average earnings basis is not adopted, the provisions for carrying forward losses as offsets (for at least 5 years) to taxable income of subsequent years should be restored.	_____	_____

	<u>Approval</u>	<u>Disapproval</u>
19. Consolidated returns should be restored and made mandatory.	_____	_____
20. Corporations should be permitted to prepare returns on the basis of a 52 week period.	_____	_____
21. All corporations should be taxed at the same rates on the first \$25,000 of net income, thus making "notch" provision unnecessary.	_____	_____

Undistributed profits tax

22. The remnant of the undistributed profits tax retained in the 1938 Act, should be removed once and for all, leaving no suggestion to future legislative bodies to resurrect it from oblivion.	_____	_____
23. The undistributed profits tax is sound in principle, and should be incorporated in the tax law in a more effective manner than is the case in the 1938 Act.*	_____	_____
24. The doubt as to amount of dividends paid credit where distribution is made in stock or cash at option of stockholder (per Section 115(b) (2)), should be resolved.	_____	_____
25. In its present form, Section 28 providing for the Consent Dividends Credit is one of the most complicated sections of the law, embodying half a dozen baffling problems, and it should be supplanted by a simple scheme whereby stockholders may pick up pro-rata shares of corporate income without going through a highly complicated procedure.*	_____	_____
26. Many attorneys have felt serious doubt over the attempt made in Regulations 94 to reconcile the conflict contained in subsections (f) and (h) of Section 27 of the 1936 Act. This conflict still remains in subsections (g) and (i) of Section 27 of the 1938 Act and it seems desirable to have the	_____	_____

matter clarified by an amendment approving the principles of Regulations 94 in this regard.

Approval

Disapproval

Capital stock and excess-profits taxes

27. The capital stock tax and the related excess-profits tax should be repealed.
28. If the capital stock tax be retained, the adjusted declared value should be reduced by Federal income taxes and excess capital net losses.
29. The excess-profits tax, if retained, should be based upon predictable ordinary business net income and should exclude capital gains and losses.
30. In view of constitutional doubt expressed in a recent court decision where the declared value covers more than one year, it is recommended that annual re-declarations of value be permitted.
31. If annual re-declarations of value are permitted, the excess-profits tax should be computed on the basis of the income-tax year commencing after the declaration date instead of on the basis of the income-tax year ending after the declaration date, as at present.
32. Combine capital stock tax return with income and excess-profits tax return and file the combined return a month later than the present due date of the income tax return.
33. The present capital stock and excess-profits taxes should be combined into one tax levied at the rate of one dollar per hundred dollars of net income.\*

Inventories

34. A dealer in securities or commodities is permitted to inventory securities and commodities owned. Such a dealer

	<u>Approval</u>	<u>Disapproval</u>
should also be permitted to inventory his short position in such securities or commodities.*	_____	_____
35. Where the value of inventories is substantially reduced by a general downward fluctuation such as might be caused by fluctuations of foreign exchange or tariffs, a taxpayer, regardless of his past practice, should be allowed to adopt the basis of "cost or market whichever is lower" for his inventory, provided a disclosure of the fact is made in the return. Regulations 45 (1920 Edition) provided a similar provision for the year 1920.*	_____	_____
36. The provisions of Section 22(d) of the 1938 Act, covering the "last-in, first-out inventory method", are too narrow. The sentence added to Section 22(c) of the 1938 Bill by amendment on floor of the Senate (but eliminated in conference) should be reinstated.	_____	_____

Basis of property

37. The basis of depreciable property should be reduced only by depreciation allowed, in years in which allowable depreciation would have been greater. To protect the Treasury against loss of revenue through a taxpayer claiming insufficient depreciation in a year of net loss, the amount of depreciation allowable for such a year should be deducted.	_____	_____
38. Basis of property received as a gift should be fair market value at date of gift, where the property is subject to gift tax.	_____	_____
39. Basis of property received as a gift, held to be in contemplation of death, should be probate value.	_____	_____
40. Basis of property devised, where estate tax is computed on values one year after death, should be value upon which estate tax is computed.	_____	_____



	<u>Approval</u>	<u>Disapproval</u>
41. Basis of property received by a corporation on complete liquidation of subsidiary under Section 112(b) (6) should be the amount of the parent's investment in the stock of the subsidiary.*	_____	_____
42. Basis of property acquired in a transaction between persons to whom losses would be disallowed under Section 24(b), where a loss results, should be transferer's basis.	_____	_____
43. In view of the complexity of record-keeping and accounting involved in the "first-in, first out" and "identification" methods, the law should contain a provision that the basic cost of stock sold by any taxpayer is the average cost of the stock to him.*	_____	_____
44. Where stock is redeemed, and it is held that the redemption is in effect a distribution of a taxable dividend, the basis, if any, of the stock in the hands of the stockholders should either be applied against the dividend or, more logically, be applied to their other holdings of stock in the corporation.	_____	_____
<u>Capital gains and losses</u>		
45. Capital gain and loss items should be removed entirely from the field of items constituting taxable net income.	_____	_____
46. There is no logical reason for aggregating short-term from long-term capital gains and losses - all capital gains and losses should be treated as long-term capital gains and losses are treated under the 1938 Act.	_____	_____
47. The short-term net loss carry-over under the 1938 Act should be extended to five years instead of one.	_____	_____
48. A long-term net loss carry-over should also be permitted.	_____	_____
49. Capital gains and losses of corporations and individuals should be treated alike.	_____	_____

	<u>Approval</u>	<u>Disapproval</u>
50. Since capital gains are taxable in full to corporations, corporate capital net losses should also be allowed in full.	_____	_____
51. Land used in trade or business should be excluded from the definition of capital assets.	_____	_____
<u>Recognition of gain or loss</u>		
52. Improvements by lessees, which are not removable or separately disposable, should not be considered as income to lessor until the latter disposes of such improvements.*	_____	_____
53. To avoid a constant annoying difference between the books and tax returns, loss or gain on the trade-in of business property should be recognized.	_____	_____
54. In view of the Supreme Court decision on March 28, 1938 in the <u>Hendler</u> case, Section 112 (d) should be amended to permit the bona fide assumption by a transferee of pre-existing liabilities of a transferor without impairing the tax-free status of an exchange or reorganization. To protect the Treasury, such an amendment should provide for situations where the assumption of liabilities by the transferee is in substance the receipt of cash by the transferor.	_____	_____
55. In connection with income from cancellation of indebtedness, the law should provide that there shall <u>not</u> be included in gross income indebtedness cancelled, in whole or in part, as a result of an adjudication in bankruptcy, or by virtue of an agreement with one or all of the debtor's creditors, if immediately <u>before</u> cancellation, the debtor's liabilities exceed the value of his assets.	_____	_____
56. No taxable income should be recognized for income tax purposes in connection with the discharge of obligations of the taxpayer unless such discharge occurs within the same taxable year <u>as</u> that in which the obligations were created.	_____	_____

Deductions

57. Under the present interpretation of the law as it affects deduction of taxes, taxes are deductible only in the period in which they legally accrue. Most businesses keeping their books on the accrual basis, make a practice of providing for, or writing off, taxes to profit and loss in aliquot monthly portions spread over the period in which the income upon which the tax is based occurs, or in which the benefits derived from the tax is enjoyed. To avoid this petty annoying difference between book deductions and tax returns, taxes should be deductible when accrued by the taxpayer in accordance with his regular accounting procedure. \_\_\_\_\_
58. The law should contain a provision that if the difference between the actual payments of accrued items of any year and the amount accrued therefor is negligible, or less than 1% of the net income in the year of accrual, no adjustments should be made. \_\_\_\_\_
59. Expenses incurred in the production of taxable income should be allowed as deductions even though such income does not arise from a trade or business. \_\_\_\_\_
60. Section 183(c) should be amended to allow partnerships deduction for charitable contributions up to the 15% limitation, regardless of the charitable contribution deductions taken by the individual partners. \_\_\_\_\_
61. Formerly where a contribution fell within the description of a business expense, the corporation was allowed a deduction in full for such contribution. Under the 1938 Act, such contributions are subject to the 5% limitation. However, in the House Ways and Means Committee Report on the 1938 Bill, it is stated that "a deduction is not to be disallowed under section 23(a) (2) of the bill merely because the recipient of amounts received from the corporation is a so-called charitable organization within the meaning of section 23(q), as, for example, in the case of a payment by a mining company to a local hospital in consideration of an obligation \_\_\_\_\_

Approval

Disapproval

assumed by the hospital to provide hospital services and facilities for the employees of the company." The intent of Congress to allow corporations full deduction for contributions made for the benefit of employees, should be clearly set forth in the law.

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Bad debts and worthless securities

62. Under the 1938 Act, losses from uncollectible corporate obligations, in coupon or registered form, and from worthless stocks are subject to the capital gain and loss limitations. Inasmuch as such losses are essentially different from losses incurred on sales or exchanges, they should not be limited but should be allowable in full, as under prior laws. \*
63. Where there is inability to pay and the mortgage debt is compromised by the debtor transferring title to the mortgagee in exchange for a release of the obligation, the mortgagee should be allowed to deduct his loss as a bad debt. The present practice of the Department is to treat such losses as capital losses.
64. Bad debts should be deductible in year of ascertainment by taxpayer although charged off in a different year.
65. Loss or worthlessness of stock should be deductible in the year in which taken by the taxpayer provided such year is within a five-year period of which the year there occurs the event which clearly indicates that the stock is valueless is the third year.
66. The Treasury Department should be required to publish in the Internal Revenue Bulletin Service, the year in which securities are held to be worthless. As soon as a conclusion on any security is reached by the Securities Valuation Section of the Department, a statement of the year in which it is deductible should be published in the Bulletin Service. In

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Approval

Disapproval

regard to securities previously ruled to be worthless, the Department should issue a special bulletin indicating the year in which such worthless securities were held deductible. This practice would not only facilitate matters for taxpayers, but should serve to reduce controversy to a minimum.

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Personal holding companies

67. The law should contain a provision that personal holding companies, even though reporting on a cash basis, be required to take the current year's income tax liability into consideration, instead of using the tax actually paid for prior years, in computing "Title 1 A net income".

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68. Under certain circumstances, foreign corporations having no stockholders who are residents or citizens of the United States, may be subjected to the personal holding company tax prescribed by Section 401 or even to the surtax under Section 102, as the result of a literal interpretation of Sections 119(a)(2)(B), 211, 231, 102 and Title 1A. This situation should be rectified by making it clear that no corporate surtax can be asserted against a foreign corporation that is not directly or indirectly owned or controlled by citizens or residents of the United States.

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69. Title 1A should be amended to exclude all corporations which are not "incorporated pocketbooks".

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Estate and Gift taxes

70. The law with respect to the valuation of large blocks of stock should be clarified, in view of recent Board and Court decisions voiding estate and gift tax regulations which rule that the size of holdings is not a relevant factor for valuation purposes.

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Approval      Disapproval

71. The Board of Tax Appeals has held in several cases that amounts paid to charities, etc., because of a decedent's promises or pledges, are not deductible for estate tax purposes where it does not appear that such pledges were given for a fair consideration in money or money's worth. Inasmuch as such pledges are usually valid and legal claims against the estate, there seems to be no reason why they should not be allowed as deductions for estate tax purposes in the same way that other debts of the decedent are permitted to be deducted. Accordingly, the law should be revised to permit such deduction.

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72. The present \$40,000 life insurance exemption allowed under the Federal estate tax law shall be removed.

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73. Where a gift tax has been paid on property subjected to estate tax, credit should be allowed for gift taxes at the highest gift tax rates paid, instead of at the average gift tax rate paid in the year the gift was made.

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74. The provisions of the estate tax law, as now contained in the basic 1926 Act and in the subsequent amendatory acts, should be consolidated into one act.

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Revision of Form 1120

75. In Schedule A (net income computation) Item 22, specific brief instructions relative to the 5% limitation instead of the general reference in Schedule J, may prevent oversight of the limitation or its workings with resulting excess deduction.

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76. Schedule E (Capital gains and losses) is not adaptive for instalment sales, whether the sale be in the year of the return or in a prior year. Special adaptation of the schedule for instalment sales may not be practical but in view of the frequency of instalment sales, appropriate note-references or instructions should prove helpful.

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77. Schedule K (Depreciation) does not now appear to be designed to develop the information really needed about the calculation of depreciation. The schedule does not, in the ordinary case, show the precise amount to which the depreciation rate has been applied. Column 6, for example, would not necessarily be the difference between column 3 and the total of columns 4 and 5. Nor is column 6 the base on which the depreciation is computed since depreciable asset additions during the year should have only partial weight. As a matter of audit review of the depreciation picture, it may be well to call for a tie-up between the opening and closing depreciation reserves in supplement to Schedule N, items 8g and i. Schedule K should be revised accordingly.

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78. Schedule M (Distributions to stockholders and dividends paid credit), Item 5 is designed to categorize automatically as non-taxable, a dividend in common stock distributed to holders of common stock. Inasmuch as there may be some doubt whether such a dividend is non-taxable, if there is also voting preferred stock outstanding at the same time, provision should be made for such a contingency.

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79. Under the caption of "Questions" on page 6, Item 7 might preferably be rephrased so that it is put in question form to determine whether or not the prescribed factors are present. In that way, there will be indicated the occasion for a schedule or the lack of it. In sub-division (2) calling for percentage of stock owned, it does not bring out whether the taxpayer owns the stock or the stock of taxpayer is owned by the company listed in the schedule.

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80. In preceding years, provision was made on the return for listing the schedules attached. This served a desirable control purpose. Restoration of that schedule would be valuable. The place for it can be obtained through elimination of Schedule O (changes in corporation's obligations and capital stock). As that does not have any direct tie-in with income tax aspects; or

through the contraction in space allotment for Schedule P (Nature of business).

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81. In previous returns, there were vertical lines for each three digits of the dollar figures. These lines automatically permitted uniformity in alignment and ease in reading. They were eliminated in the 1937 blank and should be restored.

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Board of Tax Appeals and Courts

82. In order to expedite the disposition of Board cases and to make less of a contest of legal or technical wits and more an adjudication on all the facts, it is suggested that the direct testimony be submitted in advance by affidavit, leaving for the trial the cross-examination of the deponents.

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83. Eliminate distinction between court actions against the collector and against the United States.

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84. To expedite board cases, permit determination of facts in a case through Commissioners or Referees in the same manner as now followed by the Court of Claims or the State and Federal Courts.

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85. Give the Board jurisdiction over claims for refund.

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86. Make it mandatory for Commissioner to take cases through courts to final decision where he does not acquiesce in Board ruling.

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Miscellaneous suggestions.

87. Section 311 should provide for allowance of refunds to transferee of overpayments by transferor.

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88. Forbid the issuance of revenue agent's reports, etc. during January, February and March of each year.\*

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	<u>Approval</u>	<u>Disapproval</u>
89. Permit individuals not in trade or business to file returns in district in which employed.	_____	_____
90. In the case of gifts of securities, interest and dividends should be accrued and considered as income to donor on cash basis.*	_____	_____
91. Option to husband and wife to file joint or individual returns should be abolished.	_____	_____
92. Waiver of Statute of Limitations should extend time for filing claims for refund as well as extending period in which additional assessment may be made.	_____	_____
93. The Supreme Court decision of January 10, 1938 in the <u>Biddle</u> case, is likely to discourage investment in foreign securities affected by the decision. Since a certain amount of foreign investment is desirable, both from a commercial and political standpoint, the Revenue Act should be amended to include a declaration that such income taxes as the British, withheld from dividends at the source, be deemed to be paid by the stockholder and, as such, should be allowable as a credit under Section 131(a).	_____	_____
94. In order that the limitation on foreign tax credits may be restored to an equitable proportion, the amendment inserted by the Senate in Section 131(b) of the 1938 Bill, but eliminated in conference, should be enacted. This amendment provided that in determining the proportion of a taxpayer's income from foreign sources, the taxpayer's entire net income (to be used as the denominator of the fraction) should be reduced by the amount of credit for dividends received from domestic companies.	_____	_____
95. Trusts created by will should be distinguished from inter vivos trusts and should be allowed the regular \$1,000 personal exemption.	_____	_____

	<u>Approval</u>	<u>Disapproval</u>
96. Individual taxpayers, like corporations, should be allowed to change taxable year without going on "annual basis".	_____	_____
97. Under Section 272 of the 1938 Act, interest is collected on deficiencies of income tax from the date the first instalment was due. Such interest should be charged only from the due date of the instalments.	_____	_____

(Signed) \_\_\_\_\_